

Internal Revenue Service

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Legend:

X =

Y =

Year =

A =

Dear :

This letter is in response to your request, dated September 6, 2011, on behalf of X and Y, for a private letter ruling under section 704(c) of the Internal Revenue Code. Specifically, rulings have been requested that X or Y (depending on which is the transferee partnership) may: (1) aggregate built-in gains and losses from qualified financial assets contributed by the transferee partnership to the transferor partnership with gains and losses from revaluations of qualified financial assets held by the transferee partnership for purposes of making section 704(c) and reverse section 704(c) allocations, and (2) continue to utilize the established aggregation methodology of the transferee partnership.

Facts

According to the materials submitted, we understand the relevant facts to be as follows. In Year, A acquired Y from another company. Prior to the acquisition, both A and the other company independently operated similar portfolios, X and Y. As a result of the acquisition, A now serves as the advisor to both X and Y, which A represents are both registered as investment companies under the Investment Company Act of 1940 and are treated as partnerships for U.S. federal tax purposes. In addition, A represents that both X and Y meet the definitional requirements to qualify as securities partnerships for purposes of section 704(c) aggregation. Currently, X aggregates gains and losses for purposes of making reverse section 704(c) allocations using the full netting approach. Y aggregates gains and losses for purposes of making reverse section 704(c) allocations using the partial netting approach.

In order to align business objectives and achieve economies of scale, A intends to merge X and Y in an assets-over merger for federal tax purposes. The parties intend for the transferee partnership to acquire all of the assets as well as assume all of the liabilities of the transferor partnership. As of the date of this letter, it is uncertain which partnership (X or Y) will be the transferee partnership. X and Y represent the following:

- (1) The transferee partnership will qualify as a securities partnership within the meaning of section 1.704-3(e)(3)(iii);
- (2) The transferee partnership will make revaluations daily in accordance with section 1.704-3(e)(3)(iii)(B)(2)(ii);
- (3) The burden of making section 704(c) allocations separately from reverse allocations is substantial;
- (4) The transferee partnership's contributions, revaluations, and the corresponding allocations of tax items are not made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that would substantially reduce the present value of the partners' aggregate tax liability;
- (5) Future allocations of income, gain, loss, and deduction will be made pro-rata, based on each partner's ownership interest; and
- (6) There will be no special allocations to a tax-exempt or any other partner in the partnership.

Law and Analysis

Section 704(c) provides that a partnership must allocate income, gain, loss, and deduction with respect to property contributed by a partner to the partnership so as to take into account any variation between the adjusted tax basis of the property and its fair market value at the time of contribution. The purpose of section 704(c) is to prevent the shifting of tax consequences among partners with respect to precontribution gain or loss. Section 1.704-3(a)(1).

Section 1.704-3(a)(2) states that except as otherwise provided, section 704(c) applies on a property-by-property basis. Therefore, in determining whether there is a disparity between adjusted tax basis and fair market value, the built-in gains and built-in losses on items of contributed property cannot be aggregated.

Section 1.704-3(a)(6) provides that the principles of section 1.704-3 apply to allocations with respect to property for which differences between book value and adjusted tax basis are created when a partnership revalues partnership property under section 1.704-1(b)(2)(iv)(f) (reverse section 704(c) allocations).

Section 704(c) allocations and reverse section 704(c) allocations must be made using a reasonable method that is consistent with the purpose of section 704(c). Sections 1.704-3(a)(1) and 1.704-3(a)(6).

Section 1.704-3(a)(10)(i) provides that an allocation method (or combination of methods) is not reasonable if the contribution of property (or event that results in reverse section 704(c) allocations) and the corresponding allocation of tax items with respect to the property are made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability.

Section 1.704-3(e)(3) sets forth a special rule allowing certain securities partnerships to make reverse allocations on an aggregate basis. Specifically, section 1.704-3(e)(3)(i) provides that, for purposes of making reverse section 704(c) allocations, a securities partnership may aggregate gains and losses from qualified financial assets using any reasonable approach that is consistent with the purpose of section 704(c). Once a partnership adopts an aggregate approach, the partnership must apply the same aggregate approach to all of its qualified financial assets for all taxable years in which the partnership qualifies as a securities partnership.

Section 1.704-3(e)(3)(iii)(A) defines a securities partnership as a partnership that is either a management company or an investment partnership, and makes all of its book allocations in proportion to the partners' relative book capital accounts. Under section 1.704-3(e)(3)(iii)(B)(1), a partnership is a management company if it is registered as a management company under the Investment Company Act of 1940, as amended (15 U.S.C. 80a).

Section 1.704-3(e)(3)(ii)(A) defines qualified financial assets as any personal property (including stock) that is actively traded. Actively traded means actively traded as defined in section 1.1092(d)-1 (defining actively traded property for purposes of the straddle rules).

Section 1.704-3(e)(3)(ii)(B) provides that for a management company, qualified financial assets also include the following, even if not actively traded: shares of stock in a corporation; notes, bonds, debentures, or other evidences of indebtedness; interest rate, currency, or equity notional principal contracts; evidences of an interest in, or derivative financial instruments in, any security, currency, or commodity, including any option, forward or futures contract, or short position; or any similar financial instrument.

Section 1.704-3(e)(3)(iv) and (v) provide two allocation methods of making allocations on an aggregate basis that are generally considered to be reasonable, partial netting and full netting, respectively.

The aggregation rules of section 1.704-3(e)(3) generally apply to only reverse section 704(c) allocations. Therefore, a securities partnership using an aggregate approach must generally account for any built-in gain or loss from contributed property separately. The preamble to section 1.704-3(e)(3) explains that the final regulations do not authorize aggregation of built-in gains and losses from contributed property with built-in gains and losses revaluations because this type of aggregation can lead to substantial distortions in the character and timing of income and loss recognized by contributing partners. T.D. 8585, 1995-1 C.B. 120, 123. However, the preamble also recognizes that there may be instances in which the likelihood of character and timing distortions is minimal and the burden of making section 704(c) allocations separate from reverse section 704(c) allocations is great. Consequently, section 1.704-3(e)(4)(iii) authorizes the Commissioner to permit, by published guidance or letter ruling, aggregation of qualified financial assets for purposes of section 704(c) allocations in the same manner as that described in section 1.704-3(e)(3).

Section 708(a) provides that an existing partnership shall be considered as continuing if it is not terminated. Section 708(b)(2)(A) provides that in the case of a merger or consolidation of two or more partnerships, the resulting partnership shall, for purposes of this section, be considered the continuation of any merging or consolidating partnership whose members own an interest of more than 50 percent in the capital and profits of the resulting partnership.

Section 1.708-1(c)(3) provides that when two or more partnerships merge or consolidate into one partnership under the applicable jurisdictional law without undertaking a form for the merger or consolidation, or undertake a form for the merger that is not an assets-up form, any merged or consolidated partnership that is considered terminated under this section is treated as undertaking the assets-over form for federal income tax purposes. Under the assets-over form, the merged or consolidated partnership that is considered terminated under this section contributes all of its assets and liabilities to the resulting partnership in exchange for an interest in the resulting partnership, and immediately thereafter, the terminated partnership distributes interest in the resulting partnership to its partners in liquidation of the terminated partnership.

Conclusion

Based solely on the information submitted and the representations made, we conclude that X or Y (whichever is the transferee partnership) may aggregate the built-in gains and losses from qualified financial assets contributed upon the merger of X and Y with gains and losses from revaluations of qualified financial assets held by the transferee partnership for purposes of making section 704(c) and reverse section 704(c) allocations. Furthermore, we also conclude that X or Y (whichever is the transferee partnership) may continue to utilize the established aggregation methodology of the transferee partnership.

Except as specifically ruled upon, we express no opinion on the federal tax consequences of the transaction described above under any other provision of the Code and regulations. Specifically, we express no opinion concerning whether either portfolio was qualified to and properly aggregating reverse section 704(c) allocations prior to the merger.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Pursuant to the power of attorney on file with this office, a copy of this ruling will be to your authorized representative.

Sincerely,

David R. Haglund
David R. Haglund
Chief, Branch 1
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2)
Copy of this letter
Copy for section 6110 purposes

cc: